ETF Mid-Year Market Review & Outlook Report

ETF trends in volatile markets, rising inflation, and growing uncertainty

Mark Raes,
Managing Director, Head of Product, BMO ETFs

2022 has been a challenging year for markets, regardless of asset class, ETFs have helped investors navigate the market's volatility, as liquid easy to use, single ticket solutions to reposition portfolios. With both equities and bonds in decline, portfolio construction has been difficult in 2022. With the rise of inflation, the Russian invasion of Ukraine, and most recently fears of an economic slowdown based on aggressive central bank activity to slow inflation, ETFs are effective tools to adjust portfolio risk and move across geographies, factors, and the fixed income market. Investors are weighing how persistent heightened inflation will change forecasts, and repositioning with ETFs.

ETFs asset gathering has continued with another strong start to the year, despite market risks, with over $17 billion in net new asset flows in Canada, across asset classes, including equity, fixed income and balanced solutions.[1]

Global ETF flows

Global ETF assets under management stand at 8.9 trillion in USD as of June 2022, with net new assets of $464 billion. Year over year assets are down -5% as a result of poor markets. At the end of June 2022, the Global ETF industry had 9,031 ETFs, with 18,477 listings, from 609 providers on 78 exchanges in 63 countries.[2]

Through June 30 of 2022, the Canadian ETF industry reported $291 billion in assets, while lower than December 2021, this was a result of lower markets, as the industry reported $17 billion in net inflows. Thirteen ETFs reported more than $500 million in inflows, and with well over 1000 tickers from 42 providers, the ETF industry has moved beyond its early concentration of product offerings. Inflows remain concentrated, as the top four providers by assets under management, including BMO ETFs, captured over 70% of net new asset. 21 BMO tickers reported inflows greater than $100 million.[1]

In Canada, breaking down inflows by asset class, equity ETFs led the way with over $10 billion in net new flows, as investors added to positions despite falling markets. Canadian equity led the way, capturing over 40% of the equity inflows, based on stronger relative market returns and higher exposure to energy companies. Fixed income faced the most challenging conditions in recent history, as investors struggled to evaluate inflation that hasn't been seen in over a generation, yet still had $5 billion in net inflows. Balanced ETFs continued to gain acceptance, capturing over $1 billion in net inflows, by appealing to investors as one ticket solutions. Now with track records that exceed three years, balanced ETFs have a performance history to satisfy return focused investors. Commodity ETFs experienced the largest net outflows year to date, in particular those with exposure to gold. Crypto ETFs, despite a collapse in pricing, were relatively flat in capital flows. At the ticker level, **BMO Equal Weight Banks Index ETF (ZEB)** cracked the top ten for inflows, as investors looked for the relative stability of Canadian banks combined with the steady dividend yield.

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Inflation: Are we there yet?

Alfred Lee,
Director, Portfolio Manager, BMO ETFs

Inflation continues to be the key metric that investors are focused on as the consumer price index (CPI) in both Canada and the U.S. continues to tick up to levels not seen since "the Great Inflation" of the 1980s. Both the Bank of Canada (BoC) and the U.S. Federal Reserve (Fed) have countered higher prices by tightening monetary policy through aggressive overnight interest rate hikes. The next six months will be critical as the market will look to see whether central banker's hawkish stance will be enough to tame inflation.

With aggressive assumptions for further rate hikes already priced in, leveling inflation would be the catalyst to turn the markets around. Asset prices don't need central bankers to become doves overnight, only less hawkish. With the move away from COVID-related lockdowns, it is likely that inflation will be persistent as supply will take longer to come back online. If China moves away from its zero-COVID policies, it could further alleviate many supply bottlenecks, but it's unclear whether this will be the case. Therefore, the next 6–8 months should be very telling in whether we head back towards pre-COVID levels inflation or sustained inflation consistent with the "pre-Volcker" years.

Gold has not proven to be an inflation hedge so far in 2022, as evidenced by SPDR Gold Shares ETF (GLD) returning –1.5% (in U.S. dollars). Gold rose quickly with the market stimulus back in the second quarter of 2020 but has been in decline since March of this year despite higher than expected inflation prints.

It may be tempting for investors to time the market by moving into cash. While moving small portions of a portfolio into short term fixed income ETFs such as the **BMO Ultra Short-Term Bond ETF (ZST)** will certainly allow investors to have dry powder on hand to take advantage of lower valuations, moving entirely into cash often proves to be detrimental on the long-term growth of a portfolio where staying invested generally proves to be the correct decision, regardless of immediate market conditions. Ultra short term bond ETFs picked up $819 million in net new assets over the first half of the year, as investors pulled back from markets and long term fixed income exposures.

Broad beta ETFs like the **BMO S&P/TSX Capped Composite Index ETF (ZCN)** and the **BMO S&P 500 Index ETF (ZSP)** provide investors with cost efficient ways to stay invested in the markets. Thematic ETFs such as the **BMO Global Infrastructure Index ETF (ZGI)** will provide stable revenue streams that are pegged to inflation and sector ETFs like the **BMO Equal Weight Banks Index ETF (ZEB)** are attractive from a valuation standpoint, regardless of the inflationary environment.

Sectors: Energy a clear winner

Chris McHaney,
Director, Portfolio Manager

When looking at sector performance over the first half of 2022, there was one clear winner. Energy stocks rallied on the back of oil prices rising from $75 a barrel of West Texas Intermediate (WTI) Crude Oil at the beginning of the year, to a high of over $120 during the first half of 2022. The Russian invasion of Ukraine caused already rising oil prices to spike to levels not seen since before the 2008 Financial Crisis. With Europe under immense political pressure to reduce reliance on Russian oil and gas, concerns over supply have dominated the market during the first half of the year. This led U.S. President Joe Biden to authorize a historic release from the Strategic Petroleum Reserve (SPR) – one million barrels of oil per day for six months to ease prices until more supply comes online.

In Canada, the **BMO Equal Weight Oil & Gas Index ETF (ZEO)** returned 33.3% year to date. On the back of the climbing oil price, the sector saw inflows of $730 million from Canadian ETF investors.[3] In the U.S., the sector also returned over 30% during the period. Exploration and production companies represent attractive investments if oil prices can stabilize in the $70–80 range. This provides the potential for the sector to continue its strong performance going forward, particularly over the next 6–12 months. With the sector exhibiting a bit of weakness to end the period, this may represent an opportunity for investors who missed the previous move to gain access to the sector.

The only other sector to show positive performance so far in 2022 is the defensive utilities sector, with **BMO Equal Weight Utilities Index ETF (ZUT)** returning 2.9% during the period.[4] With some ties to the energy complex, and companies that generally have high levels of current cash flow, the sector displayed its defensive traits as most others sold off. ETF investors added $273 million to the Canadian sector so far in 2022.[3]

On the other end of the spectrum, growth-oriented sectors were hit the worst, as rapidly rising interest rates caused a repricing across markets, but particularly in those areas that entered the year with higher valuations. The technology sector, which includes companies like Apple and Microsoft in the U.S., and Shopify in Canada bore the brunt of resetting valuations, with the tech-heavy **BMO NASDAQ 100 Equity Index ETF (ZNQ)** selling off 28.3% during the period.[4] With lower growth expectations for the sector going forward, investors may want to consider **BMO Covered Call Technology ETF (ZWT)** to gain exposure to this area. The covered call option overlay employed by the fund trades away a portion of potential future growth in return for consistent cash flow. This has an effect of reducing overall portfolio volatility, creating a more consistent return stream, while also providing the potential for outperformance in periods of slower equity market growth.

Low volatility and dividends offer some respite

Chris Heakes,
Director, Portfolio Manager, BMO ETFs

From a factor perspective, most notable is the shift from growth factors to defensive factors in 2022. The shift has largely been driven by rising interest rates, and the risk-off tone in markets, where the selloff in February has largely continued through the end of the first half, resulting in low volatility and dividend factors strong relative outperformance.

Dividend strategies built around companies with sustainable payouts and strong current cash flows have benefitted. BMO's dividend strategies, which focus on blue-chip quality dividend payers, have outperformed the broad indexes by 6–10% depending on region. As an example, **BMO Canadian Dividend ETF (ZDV)** has been a leading Canadian equity strategy, outperforming ZCN by 7.3% (-2.6% vs -9.9%), improving on total return versus broad equities, and significantly better than global equities, as the MSCI World Index was -19.1% (in Canadian dollars) for the first half of 2022.[4] Dividend ETFs had over $1.3 billion in net inflows over the first six months of the year.[3]

Low volatility factor is also continuing to show relative benefits, as fears of a market slowdown increased towards the end of the period. The most defensively oriented of factors has shown its worth, with **BMO Low Volatility Canadian Equity ETF (ZLB)** outperforming ZCN by 5.8% (-4.1% return vs -9.9%), as well as **BMO Low Volatility US Equity ETF (ZLU)** outperforming ZSP by a staggering 18.2% (-0.5% vs -18.7%), with its overweight defensive sectors and companies adding significant benefits.[4] Surprisingly, low volatility ETFs had close to $1 billion in net outflows over the first six months of the year.[3]

Value has outperformed this year, though it has weakened in recent weeks, as fears of recession have increased. We tend to continue to hold a positive outlook for value, though

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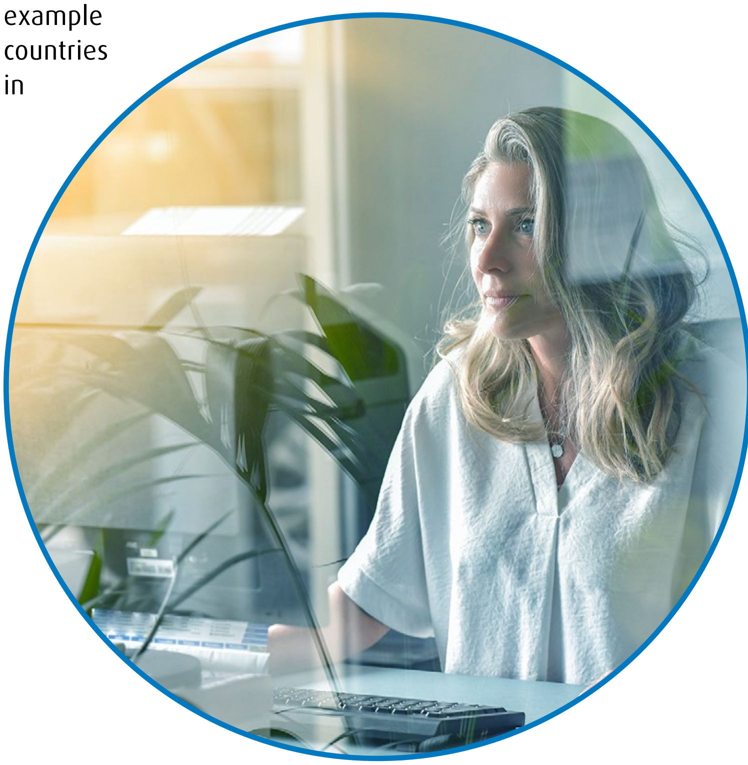
this may be in part conditional on the global economy not entering a recession, as value-oriented exposure hold more cyclical risks in general. The quality factor has underperformed so far in 2022 (largely due to the technology overweight), though it remains over the long-term a reliable factor exposure.

ESG: under a microscope

Erin Allen,
VP, Online ETF Distribution, BMO ETFs

Despite uncertain markets, geopolitical events, and a pandemic ESG ETFs continue to attract investors, dominated by institutional flows. ESG adoption continues to be greatest in Europe with North America beginning to catch up as investors continue to recognize the benefits of the approach. Inflows into ESG ETFs and new ESG ETF launches have continued although at a slower pace year to date in 2022 after a record year in 2021 where ESG ETFs had inflows of over $4 billion. In 2022 we have seen flows into ESG ETFs of over $2 billion. Equity ESG ETFs continue to lead in flows, and we continue to see momentum in the clean energy space with $177 million in inflows.[5]

The impact of Russia's invasion of Ukraine has been significant for climate change and ESG regulation, forcing companies, investors and governments to wrestle with developments that are contradictory to their ESG commitments, for example countries in



Europe turning to fossil fuels to reduce dependence on Russian gas. Whether it was Elon Musk and his comments over Tesla's exclusion from the S&P 500 ESG Index, or the recent allegations of greenwashing at major providers, there is no shortage of news on the ESG front. Regulators are acting with the Canadian Securities Administrators issuing guidance for ESG funds earlier this year clarifying disclosure requirements.

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ESG ETFs relative performance has depended on region due to higher technology exposure and lower exposure to energy companies. ZSP has returned -18.7% versus the **BMO MSCI USA ESG Leaders Index ETF (ESGY)** return of -19.7%. In Canada, we see the impact of the lower exposure to fossil fuel intensive companies driving down performance for the ESG exposure; ZCN has returned -9.9% versus the **BMO MSCI Canada ESG Leaders Index ETF (ESGA)** return of -17.7%. Performance in Canada was impacted by the lack of exposure to fossil fuel intensive businesses which are thriving due to supply imbalances caused by the geopolitical environment and Russian oil sanctions. BMO's suite of ESG Leaders ETFs targets a sector neutral exposure, including energy, which helps under normal circumstances to keep performance in line with the broad market. The ESG Leaders Indexes invest in companies that have higher ratings relative to their peers in each sector while avoiding the ESG laggards.

Innovation, Technology, and Crypto: under heavy pressure

Mark Raes,
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The rise of inflation has hit growth stocks hard, as companies valued on future cash flows now face a higher discount rate in cash flow models. As well, the aggressive action of central banks has led to fears of an economic slowdown and lower growth estimates. **BMO MSCI Innovation Index ETF (ZINN)** declined 31.2% over the period, and **BMO NASDAQ 100 Equity Index ETF (ZNQ)** declined 28.3%,[4] showing that there was little opportunity to hide with growth ETFs. Perhaps the most well known

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growth innovation strategy, ARK Innovation ETF (ARKK), declined 57.1% (in Canadian dollars)[6], testing innovation investors after an incredible run during the post-COVID market recovery. This ETF has positive inflows year to date, as investors position for the long term and buy on lower valuations. In Canada, thematic ETFs, which include these growth strategies, have had net inflows of close to $2 billion.[3]

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For crypto assets, it's been a very difficult six months, as pricing has undergone a hard correction. Purpose Bitcoin ETF (BTCC) has declined 60% over the period,[6] as crypto is no longer being considered an inflation hedge, and as other coins and stable coins have been under extreme duress. For crypto believers, it's been about taking the long view on returns, and despite significant outflows in June, crypto ETFs are close to flat on flows year to date.[3]

Fixed Income: under siege

Matt Montemurro,
Director, Portfolio Manager, BMO ETFs

2022 has been a challenging year for fixed income investors. Inflation fears, fueled by the pandemic's impact on the global economy, have come to fruition, exceeding central bank expectations, forcing them to act more aggressively with their interest rate policy. The pace at which the central banks have been forced to raise interest rates shows the severity of the problem; attempting to use aggressive interest rate policy to cool the impact of inflation. In a rarely used tactic, the Fed and BoC have both employed mega-hikes at recent meetings, increasing rates by 50bps and 75bps per meeting. This has been a main driver of fixed income underperformance, year to date. Yields have increased, across the curve, and there has been material flattening of the yield curve with shorter term rates rising at a faster pace than longer term rates.

Compounding the impact of rising interest rates, the Russian invasion of Ukraine caused credit securities to sell off. Credit spreads, both investment grade and high yield, have widened significantly, sitting well above historical norms, leading to underperformance of corporate bonds, relative to federal bonds. The combination of the negative drag on performance, due to interest rate sensitivity, and the widening of credit spreads, has left investors with very few places to hide.

Looking forward, central banks have identified that their near term priority is to get inflation under control, meaning that there is an increasing chance that they might overshoot with their interest rate policy causing an economic slowdown and possibly a recession. Even with these conditions, aggregate fixed income exposures pulled in over $3.1 billion in net inflows over the period.[3] With an eye to safety, cash ETFs pulled in close to $1.7 billion in net inflows.[3] Observing outflows of near $700 million in corporate bond ETFs,[3] higher quality corporate bonds such as **BMO High Quality Corporate Bond Index ETF (ZQB)** provides investors with more defensive exposure to A rated corporate bonds and above.

ETFs continue to lead the way as access vehicles, with the launch this year of **BMO Canadian Bank Income Index ETF (ZBI)**, investors gain access to bond and hybrid exposure to the Canadian banking sector. Pairing the stability of bank bonds with the attractive yields of bank issued preferred shares and limited recourse capital notes ZBI is well positioned to buffer the rising rate environment, offsetting some of the traditional interest rate sensitivity of fixed income.

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Looking Ahead

Mark Raes,
Managing Director, Head of Product, BMO ETFs

It's been a bumpy ride with markets this year, ETFs continue to prove their worth both strategically and tactically, as they are cost effective to hold, and efficient to trade. As indexed ETFs provide market returns, they are critical portfolio construction tools to help investors pivot in volatile markets.

ETFs have gone mainstream, their use as access vehicles for satellite positions and as core building blocks in portfolios means that they appeal across investor types and portfolios. With the continued positive momentum in industry flows, we expect that the industry will continue to offer new innovations and existing products will become even more efficient with more trading interest.

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[1] BMO Global Asset Management & Morningstar, July 2022.
[2] ETFGI Global Insights, July 2022.
[3] NBF Research Report, June 30 2022.
[4] BMO Global Asset Management, June 30 2022.
[5] NBF Research report, July 2022.
[6] Bloomberg, June 30 2022.